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SUBJECT: ECONOMIC RECOVERY A LONG WAY OFF SAY BANKERS

Summary

1. (SBU) The UK economy will not begin to recover until the end of 2009 at the earliest, and the road back to health will be slow, said Stephen King, Group Chief Economist at HSBC Bank plc and Melanie Baker, Vice President at Morgan Stanley. High loan burdens for banks, rising unemployment, and declining consumer spending will be the most significant problems of the year to come. End Summary

UK Housing and Mortgage Markets

2. (SBU) Although the current financial crisis was triggered by problems with U.S. subprime mortgages, King told econoffs in an October 28th meeting that there is little sign of a "housing bubble" in the UK. Price to income and debt to income figures have declined from their levels of two years ago, when both were higher than in the U.S., according to King. One problem that remains, however, is the loan to deposit ratio. King said that the loan to deposit ratio for UK mortgage lenders is 140 percent. (Note: The loan to deposit ratio in the U.S. has risen from about 70% in the early 1970s to about 100%. End note) In the current environment, UK lenders are working to bring down this ratio, but there is no consensus or official guidance on what the loan to deposit ratio should be. The loan to deposit ratio at Northern Rock was 215% when it was nationalized.

Macroeconomic Forecasts

4. (SBU) the UK will experience 4 - 6 years of "sluggish performance" as de-leveraging (selling off of non-performing assets to reduce debt) continues, in King's view. He forecasts that the UK bank rate will be cut from 4.5 percent to 2 percent by the fourth quarter of 2009 as the Bank of England will be forced to adopt an expansive monetary policy.

5. (SBU) King expects significant increases in unemployment. He said that much of the UK job creation under the Labour government has been in three sectors: government, financial services, and construction. Since the current economic downturn is affecting financial services and construction more than other sectors, he expects unemployment in these sectors will outpace that of the general economy. (Note: financial services contributed 20 percent to tax receipts in 2007 and 15 percent to GDP. End Note)

6. (SBU) Baker at Morgan Stanley was only slightly more sanguine in her outlook. She forecasted zero percent GDP growth in 2009 but predicted the UK economy would "muddle through" 2009 and begin to recover in 2010. However, she said that if credit conditions are seriously disrupted for a protracted period, a very sharp downturn is plausible. She put the probability of a 1990's style recession at 25 percent.

7. (SBU) In contrast to King, Baker forecasted the UK Bank rate

will decline by only .5 percent to 4 percent, possibly by the end of 2008. Baker said she expects consumer spending will be constrained by the fall in house prices and a squeeze on discretionary income for years to come. Business investment intentions have deteriorated, but in Baker's opinion, UK firms are well-placed to weather difficulties: leverage is not at extremes and corporate cash balances are high. Baker said UK unemployment is rising faster than expected although the current Morgan Stanley forecast is 5.4 percent at year-end 2009.

TUTTLE